



STATE OF WASHINGTON

OFFICE OF FINANCIAL MANAGEMENT

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December 20, 2004

The Honorable Gary Locke, Governor
Citizens of the State
Members of the Fifty-Eighth Legislature
State of Washington
Olympia, Washington 98504

In accordance with Chapter 43.88.027 of the Revised Code of Washington, the Office of Financial Management has prepared this Comprehensive Annual Financial Report (CAFR) of the state of Washington for the fiscal year that ended June 30, 2004. Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with the state. To the best of our knowledge and belief, the enclosed data is accurate in all material respects and is reported in a manner designed to present fairly the financial position and results of operations of the various funds and subsidiary accounts of the state. All disclosures necessary to enable the reader to gain an understanding of the state's financial activities have been included.

The report is presented in three sections: Introductory, Financial, and Statistical. The Introductory Section includes this transmittal letter. The Financial Section begins with the independent auditor's report and contains management's discussion and analysis (MD&A), government-wide financial statements, fund financial statements, notes to the financial statements, required supplementary information, combining financial statements, and schedules. This letter of transmittal is designed to complement the MD&A, which presents a narrative introduction, overview, and analysis of the financial statements. The Statistical Section includes selected financial, economic, and demographic data.

The state provides a wide range of services. These include education, social, health, transportation, environmental, law, public safety, resource and recreation development, public improvement, and general administrative services. The accompanying report includes all funds and subsidiary accounts of the primary government, the state of Washington as legally defined, as well as all of its component units. Component units are legally separate entities for which the primary government is financially accountable. The determination of "financial accountability" is based on criteria established in Governmental Accounting Standards Board Statement No. 14. Note 1.A to the financial statements explains more fully which organizations are included in the reporting entity.

Profile of Washington State

The state of Washington was created by an enabling act of Congress in 1889. The state is located on the Pacific Coast in the northwestern corner of the continental United States. Washington comprises 68,139 square miles and currently has a population of 5.8 million. Washington is famous for its scenery of breathtaking beauty and sharp contrasts. On the west side of the state, high mountains rise above coastal waters. The forests of the Olympic Peninsula are among the rainiest places in the world. Washington's coastline has hundreds of bays and inlets that make excellent harbors. In the eastern part of the state, the flat semi-desert land stretches for long distances without a single tree.

Washington's location makes it a gateway for land, sea, and air travel to Alaska and the Pacific Rim countries. Ships from all parts of the world dock at Washington ports. The Boeing Company, a leading producer of commercial airliners and spacecraft, has plants in Auburn, Kent, Renton, Everett, and Spokane. Microsoft, a leader in the computer software industry, makes its home in Redmond. The Weyerhaeuser Company, a major producer of wood and related products, is headquartered in Federal Way. Costco Wholesale Corporation, headquartered in Issaquah, operates an international chain of membership warehouses.

East of the Cascade Mountain Range, farmers raise livestock and wheat on large ranches. Washington leads the nation in apple production. The state produces large amounts of lumber, pulp, paper, and other wood products. The mild moist climate in western Washington makes the region excellent for dairy farming and the production of flower bulbs.

Governmental Structure

As established in the State Constitution, the state consists of three branches of government: the Executive Branch, the Legislative Branch, and the Judicial Branch. The Executive Branch has nine elected officials as follows: the Governor, Lieutenant Governor, Secretary of State, State Treasurer, State Auditor, Attorney General, Superintendent of Public Instruction, Commissioner of Public Lands, and Insurance Commissioner. Forty agency heads are appointed by, and report to, the Governor. Eighty-eight agency heads report to a board appointed in whole or in part by the Governor. The Legislative Branch consists of two legislative bodies: the Senate consisting of 49 members, and the House of Representatives with 98 members. The Judicial Branch consists of the State Supreme Court that is the highest court in the state comprised of nine Justices. Every two years, three Justices are elected for six-year terms. A Chief Justice is chosen from among the most senior Justices.

Washington State's Economy and Revenue Outlook

Since the economic recovery began in the 4th quarter of 2001, Washington has gained 48,000 jobs, or about 1.8 percent growth. Although the state job recovery has been slow, it has been stronger than that of the U.S., which saw less than 1 percent job growth in that same time period. The state recovery has been aided by a slowing of layoffs in the aerospace industry, the stimulus derived from federal tax cuts and deficit spending, very strong growth in the housing sector due to low interest rates, and an increase in disposable household income from home mortgage refinancing.

The relative strength of the state's recovery reflects the underlying strengths of the state economy, which include a vital export base, the presence of knowledge-based industries such as business,

professional, health, and financial services, and a high quality of life that continues to support strong population growth.

After two years of decline, Washington State's non-farm payroll employment grew by 0.8 percent in Fiscal Year 2004. Personal income grew at a rate of 3.8 percent that fiscal year, a significant improvement over growth rates of 2.6 percent in Fiscal Year 2002 and 2.2 percent in Fiscal Year 2003. Prior to Fiscal Year 2001, Washington's personal income was growing at rates that regularly exceeded 7 percent. The aerospace industry continued its decline into Fiscal Year 2004 with an employment decline of 11.4 percent. Total manufacturing employment declined by 4.5 percent. This extended the trend of the last three consecutive years of employment decline in manufacturing. In Fiscal Year 2004, Washington's unemployment rate receded to 6.9 percent, slightly below the levels of the last two fiscal years. As late as Fiscal Year 2000, the state's unemployment rate was below 5 percent.

Washington's outlook for Fiscal Year 2005 is for a stronger rebound in economic activity. Non-farm payroll employment in Washington is forecast to increase in Fiscal Year 2005 by 2.1 percent, the strongest growth since Fiscal Year 2000. Personal income growth is also predicted to rebound to 5.2 percent in Fiscal Year 2005, more reminiscent of the pre-recession Washington economy. General Fund-State revenues are forecast to grow at a stronger 9.6 percent rate in the 2003-05 Biennium, compared to the decline of 0.6 percent in the 2001-2003 Biennium due to the recession.

Economic Condition in Fiscal Year 2004

Washington's non-farm payroll employment grew by only 0.8 percent in Fiscal Year 2004, but this was a faster rate than the 0.2 percent increase in U.S. non-farm payroll employment. Washington non-farm payroll employment increased by almost 20,000 during Fiscal Year 2004. Personal income in Washington grew somewhat slower than U.S. personal income, 3.8 percent in Washington compared to 4.6 percent for the U.S. Real per capita income growth was up in Washington by 0.8 percent over the same period compared to 1.7 percent for the nation as a whole.

Aerospace employment was a major factor in the year's slow employment growth for Washington. After adding more than 15,000 employees in Fiscal Year 1998, employment in the aerospace industry fell by almost 41,000 in Fiscal Years 1999 through 2003. Aerospace employment continued its decline in Fiscal Year 2004, falling by 8,000. Most other manufacturing industries also continued to decline in Fiscal Year 2004. Manufacturing employment excluding aerospace in Washington declined by 4,300 jobs in Fiscal Year 2004, a reduction of 2.1 percent.

Employment in durable manufacturing other than aerospace fell by 1.5 percent in Fiscal Year 2004 (a decline of 1,800 jobs) while employment in durable manufacturing nationally declined by 3.5 percent. Employment actually increased in several durable manufacturing industries in Washington during Fiscal Year 2004. Employment in electrical equipment, appliances and components grew by 3.1 percent and employment in other transportation equipment (transportation equipment other than aerospace) increased by 7.8 percent. Employment in other durable manufacturing increased by 0.2 percent and employment in wood products rose by 0.3 percent. All other durable manufacturing sectors experienced declining employment. Employment in fabricated metal products decreased by 0.7 percent in Fiscal Year 2004. Machinery manufacturing experienced declining employment at the rate of 0.8 percent during Fiscal Year 2004. The largest percentage declines occurred in the primary metals industry, down 10.3 percent (a decline of 600 jobs), and the computer and electronic products industry, down 8.6 percent (a loss of 2,100 jobs).

Non-durable manufacturing employment in Washington decreased by 2.9 percent in Fiscal Year 2004, a loss of 2,400 jobs. Nationally, non-durable manufacturing employment declined by 3.5 percent. In Washington, all non-durable manufacturing industries experienced employment losses in Fiscal Year 2004. The largest percentage losses in employment occurred in printing, a 6.6 percent decline, and other non-durables, a 4.6 percent loss. Paper and paper products manufacturing employment decreased by 3.5 percent.

Washington's non-manufacturing employment grew by 1.4 percent during Fiscal Year 2004, with construction employment growing by 3 percent, services employment increasing by 1.8 percent, and employment in the financial activities industry rising at a rate of 2.9 percent. State and local government employment grew by 0.5 percent, but federal government civilian employment declined by 0.3 percent in Fiscal Year 2004. Wholesale trade employment rose by 1.4 percent, retail trade employment grew by 1.1 percent, and transportation, warehousing and utilities employment increased slightly by 0.2 percent. Employment in the information sector fell by 1 percent and employment in natural resources declined by 0.6 percent in Fiscal Year 2004.

Economic Outlook

The economic forecast for Washington State for Fiscal Year 2005 reflects the impact of the long-awaited recovery at both the state and national levels. According to the November 2004 forecast by the state Economic and Revenue Forecast Council (ERFC), growth in Washington's non-farm payroll employment is predicted to increase by 2.1 percent in Fiscal Year 2005, a rate closer to the state's long-term average employment growth and significantly higher than the expected national growth rate of 1.6 percent for non-farm payroll employment in Fiscal Year 2005.

Washington's personal income growth will rebound in Fiscal Years 2005 with growth of 5.2 percent. After lagging behind the U.S. for several years, Washington's personal income growth will grow at about the same rate as U.S. personal income growth, which is predicted to be 5.3 percent in Fiscal Year 2005. Employment growth in manufacturing, including aerospace and in information, will help push Washington's personal income up to the national level in Fiscal Year 2005.

Manufacturing employment in Washington is projected to resume growing in Fiscal Year 2005. Aerospace employment is expected to grow slightly in Fiscal Year 2005, by 0.7 percent. Other manufacturing sectors are also expected to show some increase in employment, adding about 1,900 jobs (a 1 percent increase) in Fiscal Year 2005. Most sectors of durable manufacturing are expected to increase in employment. The fastest employment growth is expected in machinery, at 5.8 percent, electrical equipment, appliances and components, at 5.5 percent, and other transportation equipment, at 6.5 percent. Most sectors of non-durable manufacturing are expected to continue declining in Fiscal Year 2005. Employment in food manufacturing is forecast to fall by 2.9 percent, and employment in paper and paper products manufacturing will decline by 2.5 percent. Employment in other non-durables manufacturing should grow by 1.4 percent in Fiscal Year 2005.

In the non-manufacturing sectors, the strongest growth is predicted to occur in the construction sector. Construction employment is forecast to grow by 3.9 percent in Fiscal Year 2005. Services employment growth is expected to be another bright spot in the recovery. Employment in that sector should grow by a relatively robust 3.6 percent in Fiscal Year 2005.

With the exception of federal government civilian employment, all other non-manufacturing sectors are expected to increase employment. Retail trade employment is forecast to show slightly

positive growth of 0.9 percent, and wholesale trade employment is expected to increase by 2.1 percent in Fiscal Year 2005. Information employment should grow modestly with an increase of 1 percent in Fiscal Year 2005. Employment growth in transportation, warehousing and utilities employment is predicted to grow by 2.3 percent, and employment in the natural resources industries is forecast to grow by 2.8 percent in Fiscal Year 2005. After significant budget cuts in previous years, state and local government employment is expected to grow by 1.2 percent in Fiscal Year 2005.

A few Washington industries will continue to experience slow or no growth going into Fiscal Year 2005. Federal government civilian employment is forecast to fall in Fiscal Year 2005, by 1.3 percent. The slowest growth performance among the non-manufacturing sectors is predicted to occur in the financial activities industry. Employment in this industry is expected to increase by only 0.4 percent in Fiscal Year 2005, perhaps reflecting rising interest rates and a slowdown in mortgage refinancing.

General Fund-State Revenues

General Fund-State revenues for the 2001-03 Biennium were \$21.1 billion, a decrease of 0.6 percent in nominal terms over the previous biennium. Without the effect of voter-approved initiatives and legislated tax cuts, which lowered taxes and diverted revenues from the General Fund, revenues would have grown by 1.9 percent in the 2001-03 Biennium.

Revenue growth is expected to rebound in the 2003-05 Biennium. General Fund-State collections are forecast to increase by 9.6 percent during that two-year period, generating revenue of \$23.2 billion. A series of revenue enhancements including the addition of more auditors to the Department of Revenue, an increase in fines and penalties related to delinquent taxes, and the delay of transfers of the state property tax to local school districts to reduce class sizes helped buoy revenues. Without those additions, General Fund-State revenue would have grown by 6.1 percent in the 2003-05 Biennium.

Based on the November revenue forecast, Washington will have an estimated reserve of \$641 million by the end of the 2003-05 Biennium, up slightly from \$462 million in the previous biennium. These projected reserves assume no further changes in appropriations for the 2003-05 Biennium.

Major Initiatives

Washington continued its multi-year effort in 2004 to improve the state's public education system, make state government more efficient and responsive, promote economic development, and protect and make wiser use of natural resources. In his final year in office, Governor Locke left Washington in solid financial health despite the effects of a severe and lingering economic downturn.

Public Education

The Legislature and Governor Locke took additional steps in 2004 to improve the quality of primary and secondary education in Washington. Among them were improvements to the Washington Assessment of Student Learning achievement tests. Students are now allowed to retake the tests and use alternative ways to show they have met state standards in reading, writing and math - a requirement to graduate beginning in 2008. Other improvements include a stronger Learning

Assistance Program to help underachieving K-12 students with reading, mathematics and writing. Technical help is provided to schools that fail to meet academic improvement goals, and permission was given for school districts to collect the full amount of voter-approved school levies to offset recent state budget reductions.

Higher Education

Governor Locke and the Legislature created 3,000 badly needed enrollment slots at state colleges and universities, providing Washington businesses more skilled workers to strengthen the economy. About one-third of the \$17 million enrollment increase is in high-demand fields including information technology, nursing and engineering. Also provided were \$111 million in construction funds to expand and improve facilities at state colleges and universities, and \$2.3 million to continue offering \$1,200 Promise Scholarships to high-achieving high school seniors.

Economic Development

Efforts continued in 2004 to improve the ability of business to thrive in Washington. The Governor and Legislature provided \$86 million worth of business tax incentives to help Washington keep its competitive edge, including \$68 million for technology research and development, and to attract more manufacturing jobs to rural areas.

Environment

Important steps were taken in 2004 to protect Washington's environment. Among other things, Governor Locke enacted more than \$12 million in state operating and capital funds to set in-stream flows and take other actions to improve water efficiency and reclamation. He also provided new funding of \$860,000 to reduce storm water pollution, as well as identify PBT and mercury toxins and develop a plan for removing them from the environment. In addition, he signed a law placing new limits on carbon dioxide emissions by new power plants.

Human Services

The Governor and Legislature reduced the impact of pending health care premiums to be charged to parents of children receiving state-sponsored, optional Medicaid health coverage. In addition, they provided \$24 million to fund the home-care workers contract. Home-care workers received a 50-cent per hour wage increase, worker compensation benefits and limited health care benefits.

Transportation

The \$4.2 billion transportation funding package approved in 2003 continued to be deployed to build and expand high-priority state highway projects. In 2004, Governor Locke and the Legislature appropriated \$3.5 million, with a \$9.4 million federal match, to bring the state ferry system into compliance with new United States Coast Guard security rules. In addition, the Governor enacted a law allowing motorists to renew driver licenses through the internet or mail.

Financial Management Information

Internal Controls

The state is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the state are protected from loss, theft, or misuse, and to ensure that adequate accounting data is compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. Internal controls are designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived, and (2) the valuation of costs and benefits requires estimates and judgments by management.

Washington State continues to assess the adequacy of its internal control structure and make improvements where weaknesses are found. These actions will help assure that the state maintains public accountability for years to come.

Budgetary Controls

Budgetary control is maintained through legislative appropriations and the executive branch allotment process. The Governor is required to submit a biennial budget to the Legislature. The budget is legally required to be adopted through passage of appropriation bills by the Legislature with approval by the Governor. Appropriated funds are controlled by the executive branch through an allotment process. This expenditure plan details the appropriation into monthly estimates by program, source of funds, and object of expenditure. Nonappropriated governmental funds are also subject to allotment control by the executive branch. Additionally, the state maintains an encumbrance accounting system as one technique of accomplishing budgetary control. Encumbered amounts lapse at the end of the appropriation. However, capital encumbrances are generally reappropriated as part of the following biennial budget.

The state's budgetary policies and procedures, fund accounting structure, and basis of accounting are explained in detail in the notes to the financial statements and notes to the required supplementary information.

Retirement Plans

The state administers 12 defined benefit retirement plans, three combination defined benefit/defined contribution retirement plans, and one defined contribution retirement plan covering eligible employees of the state and local governments. Note 11 to the financial statements presents plan descriptions, information on funding policies, and combining statements of plan net assets and changes in plan net assets.

Insurance Activities

The state has three insurance programs operated and accounted for as insurance businesses. Notes 1.E.2 and 7.C to the financial statements disclose the specific programs and claims liability changes during Fiscal Year 2004 for each insurance program.

Liabilities of the workers' compensation insurance activity amount to \$16.6 billion as of June 30, 2004. The liability includes \$8.2 billion for supplemental pension cost of living adjustments (COLAs) that, by statute, are not to be fully funded. These COLA payments are funded on a pay-as-you-go basis, and the Department of Labor and Industries' actuaries have indicated that future

premium payments will be sufficient to pay these claims as they come due. The remaining \$8.4 billion in claims liability is fully funded by long-term investments, net of obligations under securities lending agreements, held for payment of claims.

The risk management insurance activity liabilities amount to \$513.3 million as of June 30, 2004. The funding for this liability is limited by statute to a maximum of 50 percent. This liability is currently funded by \$71 million in cash and pooled investments.

Health insurance activities have liabilities as of June 30, 2004, amounting to \$66.9 million that are fully funded with cash and investments, net of obligations under securities lending agreements.

Other Information

Independent Audit

State statutes require an annual audit by the Office of the State Auditor. The State Auditor is an independently elected public official. The state is also required to undergo an annual single audit in conformity with the provisions of the Single Audit Act of 1984 and U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

The State Auditor conducts the audit of all state agencies. In addition to meeting the requirements set forth in state statutes, the audit is also designed to meet the requirements of the federal Single Audit Act. The Auditor's report on the basic financial statements is included in the financial section of this report. The Auditor's report related to the single audit, including the schedule of federal financial assistance, findings and recommendations, and reports on internal control structure and compliance with applicable laws and regulations, will be published in a separate report. When completed, the report will be available on the Office of Financial Management website at: <http://www.ofm.wa.gov>.

Awards

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to Washington State for its Comprehensive Annual Financial Report for the fiscal year that ended June 30, 2003. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a governmental unit must publish an easily readable and efficiently organized Comprehensive Annual Financial Report, with contents conforming to program standards. Such reports must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. Washington State has received a Certificate of Achievement for the last seventeen years. The Office of Financial Management considers this report to be in conformance with the Certificate of Achievement Program requirements, and will submit it to the GFOA.

Acknowledgment

The preparation of this report could not have been accomplished without the professionalism and dedication demonstrated by the financial and management personnel of each state agency and institution of higher education, and the Office of Financial Management.

This Comprehensive Annual Financial Report reflects the commitment of the Governor to the Legislature, the citizens of Washington State, and the financial community to maintain financial statements in conformance with the highest standards of financial accountability.

Sincerely,

A handwritten signature in black ink that reads "Marty Brown". The signature is written in a cursive, flowing style.

Marty Brown
Director

